Decision Making and Investment Manager Evaluation

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Abstract

There is a perfect storm developing for investment program governance when considering the combination of the most likely capital market environment, the typical committee decision making process, and the most common investment manager evaluation criteria. Despite the rebound from the depths of the 2008 economic crisis, global economies face a number of challenges that are likely to take the better part of the next decade to solve. PIMCO has theorized that the next few years will be filled with de-leveraging, de-globalization, and re-regulation ("D D R") – the result of this process is likely to be a continuation of the heightened market volatility experienced during the last decade. Economic growth will exist, but it is likely to be scattered across the globe by region, country, industry, and even company. At the same time, the typical committee decision making process focuses a great deal on the outcome (performance results) of investment decisions. Furthermore, most investment policy statements and manager directives include evaluation criteria focusing on one and three year rolling returns versus a given benchmark and manager universe. The combination of all three factors could make investment program governance a challenge over the next decade. Much has been written about the global economic outlook so this paper will not seek to build a case for any specific scenario. The only assumption made regarding the global economic environment is that it will continue to be volatile and that the capital markets are likely to follow suit. Given that base, this paper will offer a suggested framework for effective committee decision making as well as a more effective framework for investment manager performance evaluation.

Decision Making

Michael Mauboussin has written extensively about the characteristics of a successful investment program and two of his publications, *More Than You Know: Finding Financial Wisdom in Unconventional Places* and "Investment Committees: How to Build a Team to Make Good Decisions", speak specifically to decision making and investment committee structure and functioning. Mauboussin's recommendations can be summarized in two simple statements:

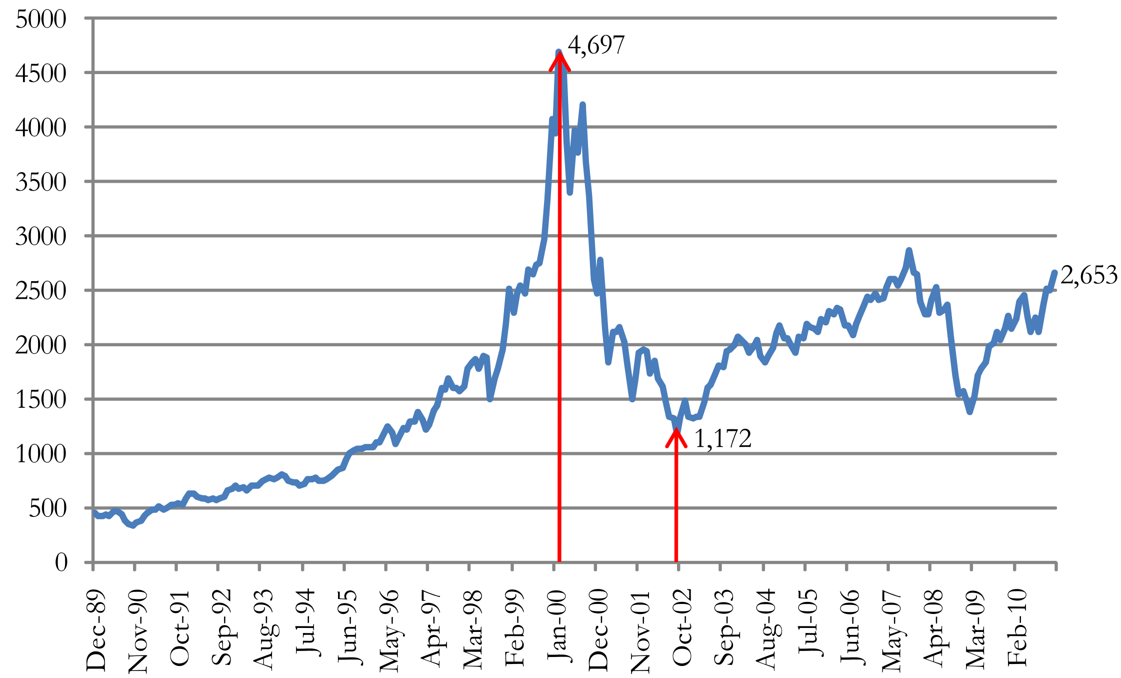
1. Focus on the process, not the outcome; and
2. Focus on the long-term, not the short-term.

Focus on the Process, Not the Outcome

The preceding statement, to use a common idiom, is easier said than done. Results are easily measured, clearly defined, and easily compared – they are the most clear and effortless path for evaluating a decision. The problem with focusing solely on the results is that it completely ignores how the results were achieved. Robert Rubin, Secretary of the Treasury under President Clinton, expressed it well in his 2001 commencement address at Harvard University, "Individual decisions can be badly thought through, and yet be successful, or exceedingly well thought through, but be unsuccessful, because the recognized possibility of failure in fact occurs. But over time, more thoughtful decision-making will lead to better overall results, and more thoughtful decision-making can be encouraged by evaluating decisions on how well they were made rather than on outcome." Said more simply, as one colleague says, "you can walk blindfolded across an eight lane highway and not get hit by a car but that doesn't mean it was a good decision".

The 1990's offered a significant lesson for those who focused more on performance results than how those results were achieved. That period, affectionately known as the "tech bubble", posed significant challenges for individual investors, investment managers, and those responsible for investment program governance. Despite stern warnings from the Fed Chairman Alan Greenspan and legendary investors including Warren Buffett, many investors piled into growth stocks of varying quality late in the 1990's. They were lured by the stellar returns and the social pressure of missing out on the new economy. While those that focused on the process endured some challenging times, they were quickly rewarded as the NASDAQ peaked in March 2000 and quickly retreated. **Figure 1** shows a price chart of the NASDAQ Composite from 1990 – 2010.

Figure 1: NASDAQ Composite Closing Price - Monthly December 1989 to December 2010



Source: Factset

As the chart illustrates, it took only 31 months to wipe out the gains of the preceding four years. Even eight years later, the NASDAQ has only recovered to 56% of peak value in March 2000.

How do the late 1990's and the NASDAQ relate to process versus outcome? Investing tends to be a social activity and institutional committee decision making is the height of social pressure (Mauboussin). From the internal pressure within the committee to the cocktail party conversations comparing both personal investment performance and various volunteer board membership results, peer pressure and group think can wreak havoc on a committee decision making process. The late 1990's brought the era of the "dot coms" where stock price valuations were driven by outlook and accounting earnings instead of cash flow and real world earnings. In fact, many of the most popular stocks had never actually turned a profit despite their meteoric rise in market capitalization and institutional stock ownership. In the end, those investment managers and investment committees that focused more on traditional valuation techniques that emphasized quality, balance sheet strength, and earnings (the process) were rewarded with strong performance during 2000-2002 when the broader market and the NASDAQ in particular collapsed. Those who focused more on results found themselves chasing returns and likely experienced a disappointing long-term outcome.

Focus on the Long-Term, Not the Short-Term

As with the process versus outcome debate, long-term focus is a common sense practice that is very difficult to implement. Investing is a probability based exercise; therefore, the longer the time frame over which you choose to evaluate success, the greater the likelihood is that you will be successful (Mauboussin). This is especially true when investing with active investment managers. By definition, active managers will be different from the index and can, depending on their level of concentration of holdings, experience very different results than the index in a given year. While some active managers are more consistent in their success, others may go years without beating their index and then make up any underperformance in a couple of strong relative years. This type of relative performance volatility must be thoroughly understood at the inception of the strategy in order to prevent a disappointing outcome.

Patience with relative performance volatility was extremely important over the past 10 years and will, in Highland's opinion, continue to be crucial. Michael Mauboussin conducted a survey of managers that outperformed the S&P 500 from 1997-2006 where the fund had a single manager and at least $1billion in assets. Based on his survey, Mauboussin listed four traits that summarized these successful investment managers:

1. Lower portfolio turnover – approximately 35% vs. 89% for all equity funds over the same period;
2. Higher portfolio concentration – approximately 35% of assets in the top 10 holdings vs. 20% for the index (S&P 500);
3. Investment philosophy focused on valuation, regardless of growth or value style; and
4. Geographic location – many of the successful survey group were located outside of the major eastern financial centers (Boston and New York).

Interestingly enough, the 1997-2006 study was an update of Mauboussin's original study from 1995 – 2004 and ¼ of the names on the original list were also on the 2006 update. Since both study periods include the market run up in the late 1990's and the dramatic decline from 2000 – 2002, it is reasonable to assume that there were some significant short-term relative performance differences but the result of the study showed the managers' long-term success. In other words, there were many stumbling blocks in the path of short-term thinkers that could have derailed the successful long-term run for the survey list of managers.

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Along the same line of thought, Cremers and Patajisto of the Yale School of Management performed a study from 1980 – 2003 to determine whether or not active management paid off for the investor. In their research, they found:

1. Roughly a third of all managers are "closet indexers" charging active management fees;
2. Managers that looked the least like the benchmark (high active share) outperformed the benchmark by 1.13% to 1.15% per year net of fees; and
3. "Closet indexers" (funds with the lowest active share) underperformed the benchmark by 1.42% to 1.83% per year net of fees.

The conclusion from their work was that in order to get any value from the extra fees paid to active managers, those managers must be substantially different from the benchmark (high active share). Again, that large deviation from the benchmark is going to produce some volatile short-term relative performance that must be endured to achieve long-term success.

Summary: Successful Decision Making Recommendations

How do process versus outcome and long-term versus short-term evaluation periods relate to the assumed capital market environment? Results are extremely endpoint sensitive (meaning they can look good or bad depending on the end of the period of evaluation) and volatile markets can create a difficult environment for results based decision making; therefore, investors must establish a well thought out process for selecting and evaluating managers and asset classes and then stick with it. If the results are not satisfactory, re-evaluate the process before making changes solely based on disappointing results. Additionally, results are likely to be more significant and indicative of skill when using a longer period of evaluation versus a shorter period. Said differently, luck tends to run out on those who do not have a successful process when enough time is allowed to evaluate the results.

Investment Manager Performance Evaluation

Table 1 represents a survey of Highland's clients[i] for performance evaluation guidelines regarding returns versus a manager universe and performance versus an index.

Table 1: Investment Manager Evaluation Guidelines

	Manager Universe Performance					Relative Index Performance			
	1Q	1 Year	2 Year	3 Year	5 Year	1Q	1 Year	3 Year	5 Year
% of Clients Using	22.9%	60.0%	2.9%	60.0%	2.9%	0.0%	2.9%	45.7%	8.6%
# of Clients Using	8	21	1	21	1	0	1	16	3

**Source: Highland Associates; Sample Size: 35 clients*

According to the survey, the most common manager universe evaluation periods are a rolling 1 year and 3 year, at 60% each, while nearly ¼ of Highland's clients also look at universe performance on a quarterly basis. The specific hurdle established for performance against the universe varied based on the time period. The majority of the 1 year and 3 year universe comparisons required that managers rank in the top 50% while a ranking in the top 33% was also a common 3 year guideline. Rolling 3 year performance versus the index was the only significant criteria among Highland clients with close to ½ using that measure. The guidelines require that managers outperform a given index over the specified time period.

These guidelines were originally set as a reference point to trigger further review and discussion and not intended to drive a specific action on a short-term basis. However, as the guidelines were incorporated into the investment policy statement and client committee and board members rotated through over time, they became an easy measuring point and began to drive decisions on a shorter-term basis. Additionally, as the markets became more volatile during the 2000-2009 decade active managers violated the criteria more often and consumed a greater amount of time on the meeting agenda. In short, while the guidelines were well intentioned, they have become a stumbling block.

The case laid out previously for a more effective decision making process suggested a longer-term focus than the guidelines above would allow. Given that conflict, the following information outlines a real world example of investment performance and how the guidelines detailed above might have impacted the composite's long-term success.

Global Equity Example – Performance Against the Universe

The following information details the performance of 4 of the most common global equity managers[ii] used by Highland's clients. Each manager's performance was measured against the Global Equity Universe[iii] as defined by RogersCasey. **Table 2** details the results of each of the managers versus the most common performance criteria – rank in the top 50% over a rolling 1 year and 3 year basis – and violations of that criteria are noted in red. The table also lists the rolling 5 year universe comparison with rankings below 40% noted in red.

Table 2: Manager Ranking Against the Global Equity Universe

	2010	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993
Manager A - 1 year	87	57	24	23	22	27	20	33	15	20	37	57	46	32	27	47	37	N/A
Manager A - 3 year	55	30	9	16	22	28	15	15	29	32	40	47	25	37	40	47	N/A	N/A
Manager A - 5 year	36	17	9	18	17	18	26	27	10	20	35	35	31	32	N/A	N/A	N/A	N/A
Manager B - 1 year	46	57	14	36	68	12	84	94	13	25	49	36	48	N/A	N/A	N/A	N/A	N/A
Manager B - 3 year	18	23	12	21	48	72	42	23	33	29	30	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Manager B - 5 year	28	14	18	63	37	25	43	31	8	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Manager C - 1 year	53	19	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Manager C - 3 year	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Manager C - 5 year	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Manager D - 1 year	90	63	39	50	7	58	29	40	40	27	41	58	63	55	32	35	55	27
Manager D - 3 year	77	59	25	23	23	43	32	27	41	36	56	65	58	43	41	22	N/A	N/A
Manager D - 5 year	55	43	36	37	42	45	61	39	41	44	50	48	42	35	N/A	N/A	N/A	N/A

**Source: RogersCasey*

Table 2 outlines numerous policy violations by the four managers in the example composite. There were 15 separate 1 year performance criteria violations (rank in the top 50%) and 7 separate 3 year performance criteria violations (rank in the top 50%) over the 18 year history of the composite. On a rolling 5 year basis, there were 12 periods where the managers ranked higher than 40% (with 8 of those periods ranking between 40-50%).

Global Equity Example – Performance Against the Index

Table 3 details the relative performance of each of the managers versus the MSCI AC World Index[iv]. Violations of the most common performance criteria – outperform the MSCI AC World Index on a rolling 3 year basis [the rolling 1 year and rolling 5 year comparisons are also listed] – are noted in red.

Table 3: Manager Under/Outperformance Against the MSCI AC World Index

	2010	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993
Manager A - 1 year	-5.5%	-3.1%	3.4%	5.3%	0.9%	3.3%	3.6%	4.5%	11.9%	11.0%	15.3%	0.5%	-5.8%	3.0%	8.3%	1.9%	-3.8%	N/A
Manager A - 3 year	-0.5%	2.6%	3.5%	3.3%	2.7%	3.8%	7.4%	10.0%	12.7%	9.9%	4.5%	-0.8%	1.9%	4.4%	1.9%	N/A	N/A	N/A
Manager A - 5 year	0.8%	2.5%	3.6%	3.5%	5.4%	7.5%	10.0%	9.6%	7.7%	5.8%	4.9%	1.6%	0.6%	N/A	N/A	N/A	N/A	N/A
Manager B - 1 year	1.6%	-3.3%	7.4%	2.1%	-5.3%	8.1%	-7.0%	-11.4%	13.7%	9.2%	8.4%	20.6%	-7.4%	N/A	N/A	N/A	N/A	N/A
Manager B - 3 year	3.6%	3.7%	2.9%	1.7%	-1.4%	-3.2%	0.1%	5.7%	10.5%	11.9%	6.8%	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Manager B - 5 year	1.7%	3.0%	2.1%	-2.5%	0.7%	3.8%	4.1%	8.7%	9.0%	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Manager C - 1 year	0.3%	13.8%	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Manager C - 3 year	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Manager C - 5 year	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Manager D - 1 year	-6.4%	-4.4%	0.3%	-2.0%	7.0%	-1.0%	2.0%	3.0%	1.6%	8.2%	13.6%	0.3%	-13.7%	-2.2%	7.7%	3.8%	-5.1%	10.3%
Manager D - 3 year	-2.7%	-1.5%	1.3%	1.2%	2.6%	1.2%	2.1%	4.5%	7.5%	8.2%	1.1%	-5.4%	-2.8%	3.0%	1.8%	2.4%	N/A	N/A
Manager D - 5 year	-1.0%	0.1%	1.1%	1.6%	2.4%	3.0%	6.0%	5.8%	2.9%	2.2%	1.7%	-1.0%	-2.1%	2.5%	N/A	N/A	N/A	N/A

**Source: RogersCasey*

Table 3 outlines numerous policy violations by the four managers in the example composite. There were 16 separate 1 year performance criteria violations (outperform the index) and 8 separate 3 year performance criteria violations (outperform the index) over the 18 year history of the composite. On a rolling 5 year basis, there were only 4 periods where the managers underperformed the benchmark.

Global Equity Example – Composite Level Performance and Statistics

Despite the large number of policy violations by the individual managers, an equal weighted composite[v] of the example global equity managers has been very successful on a rolling basis as well as when viewed on an annual basis. **Table 4** details the performance of the equal weighted composite versus the MSCI AC World Index and the Global Equity Universe on an annual, 3 year, and 5 year rolling basis.

Table 4: Annual Composite Performance Relative to the MSCI AC World Index and Global Equity Universe

	2010	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993
Equal Weighted Composite	11.1%	36.3%	-40.6%	14.0%	22.3%	14.8%	15.3%	33.2%	-10.0%	-6.4%	-1.4%	33.8%	13.1%	16.3%	21.2%	22.3%	0.6%	34.4%
MSCI AC World Index	13.2%	35.4%	-41.8%	12.2%	21.5%	11.4%	15.8%	34.6%	-19.0%	-16.0%	-14.0%	26.8%	22.0%	15.0%	13.2%	19.5%	5.0%	24.9%
1 Year Difference	-2.1%	0.9%	1.2%	1.8%	0.8%	3.4%	-0.5%	-1.4%	9.0%	9.6%	12.6%	7.0%	-8.9%	1.3%	8.0%	2.8%	-4.4%	9.5%
1 Year Ranking	7	43	34	37	23	27	45	60	20	24	41	47	52	37	31	41	45	28
Trailing 3 Year Difference	0.3%	1.4%	1.3%	2.1%	1.3%	0.6%	3.3%	6.8%	10.3%	10.2%	4.2%	-0.5%	0.1%	4.0%	1.8%	2.1%	N/A	N/A
Trailing 3 Year Ranking	49	38	25	20	31	45	28	21	33	32	41	45	37	39	40	22	N/A	N/A
Trailing 5 Year Difference	0.6%	0.7%	1.4%	0.9%	2.9%	4.8%	6.8%	8.2%	6.7%	5.1%	4.4%	1.9%	-0.4%	3.1%	N/A	N/A	N/A	N/A
Trailing 5 Year Ranking	38	24	23	32	26	23	32	32	15	26	36	34	35	31	N/A	N/A	N/A	N/A

**Source: RogersCasey*

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Table 4 outlines the success of the example global equity composite. The composite had only 5 violations of the 1 year index performance criteria, only 1 violation – of only 50 basis points – on a 3 year basis, and only 1 violation – of only 40 basis points – on a 5 year basis. The manager universe comparisons were equally as successful with only 2 rankings below 50% on a 1 year basis and none on a 3 or 5 year basis. While the individual parts (managers) may have struggled at times, the diversification of managers by style and strategy worked and the sum of the parts (composite) performed and ranked well.

Table 5 illustrates the rolling performance of the example composite as of December 31, 2010. Performance below the benchmark or a universe ranking below 50% is noted in red.

Table 5: Rolling Composite Performance as of December 31, 2010

	1 Year	3 Years	5 Years	7 Years	10 Years	15 Years
Global Equity Composite	11.1%	-3.5%	4.6%	7.5%	6.4%	9.5%
Universe Ranking	70	49	38	33	27	30
MSCI AC World Index	13.2%	-3.8%	4.0%	6.6%	3.7%	6.3%
Universe Ranking	54	51	42	46	47	66

**Source: RogersCasey*

As the annual comparison showed, the example composite has been successful on a rolling basis, as well, despite some of the struggles of the individual managers.

While relative performance is important, the process versus outcome discussion detailed earlier would also lead to an evaluation of how those relative returns were achieved – specifically, how did the standard deviation (**Figure 2**) and downside capture (**Figure 3**) of the example composite compare to the benchmark and the universe?

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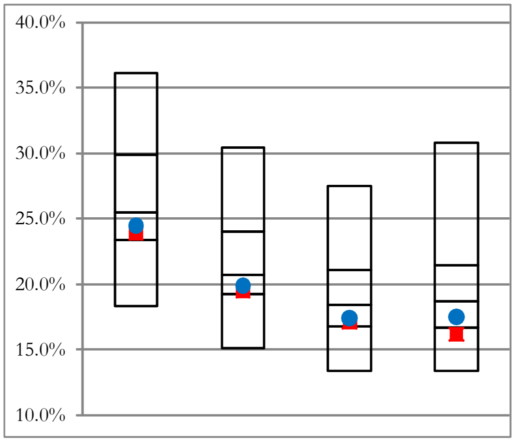
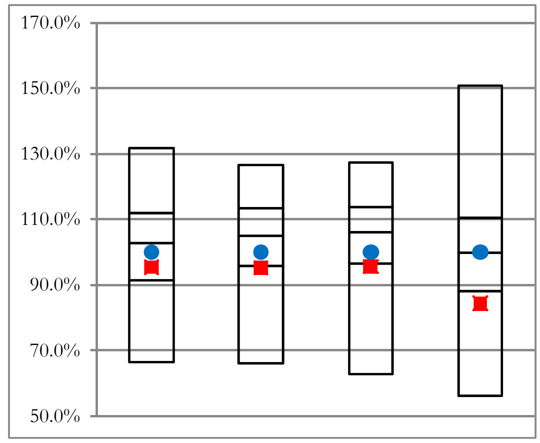
Figure 2: Composite Standard Deviation as of Dec 31, 2010



	3yr Standard Deviation	5yr Standard Deviation	7yr Standard Deviation	10yr Standard Deviation
Composite	23.9%	19.5%	17.1%	16.2%
MSCI AC World	24.5%	19.9%	17.4%	17.5%
5th Percentile	36.1%	30.4%	27.5%	30.8%
25th Percentile	29.9%	24.0%	21.1%	21.5%
Median	25.5%	20.7%	18.4%	18.7%
75th Percentile	23.4%	19.3%	16.8%	16.7%
95th Percentile	18.3%	15.1%	13.4%	13.4%

**Source: RogersCasey*

Figure 3: Composite Downside Capture as of Dec 31, 2010



	3yr Down Market Capture	5yr Down Market Capture	7yr Down Market Capture	10yr Down Market Capture
Composite	95.5%	95.3%	95.6%	84.4%
MSCI AC World	100.0%	100.0%	100.0%	100.0%
5th Percentile	131.7%	126.7%	127.5%	150.8%
25th Percentile	112.0%	113.5%	113.9%	110.4%
Median	102.8%	105.0%	106.1%	99.9%
75th Percentile	91.5%	95.9%	96.5%	88.1%
95th Percentile	66.6%	66.0%	63.0%	56.3%

**Source: RogersCasey*

Both figures illustrate that the example composite has achieved the superior relative performance noted previously with a lower level of relative volatility (standard deviation) and a lower level of absolute risk (down market capture) over varying periods of time.

Conclusion

This paper first discussed a recommendation for a more successful decision making framework for individuals and committees in order to help improve investment program governance. The evaluation then shifted to a real world example of how a global equity composite, which was very successful as a whole, might have been sabotaged by some performance criteria violations by the individual members of the composite.

The key takeaways from the paper are as follows:

1. Focus on the process, not the outcome
    a. Spend the time on the front end to understand a manager's process and then evaluate their adherence to their process more than the performance results
    b. Focus more on bigger picture items – composite performance, asset allocation, etc. – recognizing that individual manager performance discussions can highjack the process and focus too much on small details at the expense of the larger, often more important, issues

2. Focus on the long-term, not the short-term
    a. Longer-term evaluation periods are more appropriate for probability based exercises like investing
    b. Manager evaluation periods must match the manager's investment philosophy and strategy – managers with a 3-5 year horizon for their investment ideas should not be evaluated on an annual or triennial basis
    c. Specifically for manager performance – evaluate managers over rolling 5 year periods
        i. Managers should outperform the index over rolling 5 year periods
        ii. Managers should outperform 60% of similar managers over rolling 5 year periods (rank in the top 40%)

    [It is important to note that there will still be times when managers do not meet the rolling 5 year criteria. The link between performance evaluation and understanding the manager's process cannot be over emphasized.]

Highland would suggest that each client begin a process of updating investment policy statements and separate account manager directives to reflect the recommendations above. Further, Highland suggests that the quarterly performance discussions focus on composite performance and cover individual investment managers on more of an exception basis. We believe this will serve to center the discussion on the bigger picture and allocate the committee's time more to the overall performance of the investment program and how it relates to each organization's needs. In the end, the decision making and investment manager evaluation processes should not be allowed to be a stumbling block but be designed to improve the chance of a correct decision and the desired outcome.

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Resources

Books

Mauboussin, M. (2008). *More Than You Know: Finding Financial Wisdom in Unconventional Places*. New York: Columbia University Press.

Mauboussin, M. (2006). *More Than You Know: Finding Financial Wisdom in Unconventional Places*. New York: Columbia University Press.

Papers and Articles

Mauboussin, M. "Investment Committees: How to Build a Team to Make Good Decisions". Legg Mason Capital Management: Mauboussin on Strategy. September 1, 2009.

Cremers, M. and Petajisto, A. "How Active is Your Fund Manager? A New Measure That Predicts Performance". Yale ICF Working Paper No. 06-14. March 31, 2009.

Endnotes

[i] Survey was based on Highland's clients as of June 2010. Highland had 35 clients at that time.

[ii] The example managers were the four most common global equity managers in Highland's client portfolios. All four managers were on Highland's approved list for global equity mangers as of December 2010.

- Manager A – inception March 1, 1993; performance is net of fees
- Manager B – inception October 1, 1997; performance is net of fees
- Manager C – inception June 1, 2008; performance is net of fees
- Manager D – inception March 1, 1992; performance is net of fees; returns are the manager's global equity composite which was originally reported gross of fees; those returns were reduced by 60 basis points per year (5 basis points per month) to arrive at the net of fees performance

[iii] The Global Equity Universe consists of all mutual fund managers categorized as "global equity" by RogersCasey. The universe population was 1,087 as of December 2010. The universe is quoted net of fees.

[iv] The MSCI AC World Index includes all developed and developing (emerging) markets as defined by MSCI. "AC" represents "all country".

[v] The composite included each manager listed in footnote ii upon their first full month of performance. Each manager was equal weighted at their inclusion. For example, if the composite currently consisted of 2 managers weighted 50% each and a third manager was added, each manager would be weighted 33% each upon the inclusion of the third manager.

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